

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Chapter 15A Related Party Losses And Expenses

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References:

IRC §267
Treas. Reg. §1.267
R&TC §24427

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Training Objectives:

This section of the Water's-Edge Manual provides an analysis of limitations on the deductibility of losses and expenses arising from transactions between related parties. This section of the law applies to both worldwide and water's-edge taxpayers.

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a. *Introduction*

Prior to January 1, 1985, §24427 conformed to IRC §267 by incorporating stand-alone language that mirrored the language in §267. For income years beginning on or after January 1, 1985, §24427 was reworded to incorporate the provisions of IRC §267 by direct reference and the previous stand-alone language was eliminated. IRC §267 provides rules for disallowing losses and certain deductions between related parties. In the Tax Reform Act of 1986, Congress expanded the payment requirement to include transactions with foreign persons who are related to the taxpayer.

BEWARE: The federal regulations under Section 267 are a mix of final, proposed, and temporary regulations. Several provisions of the regulations have not been updated to take into account recent law changes.

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b. Restrictions Of IRC §267

In general, §267 imposes the following restrictions on related party transactions:

1. **IRC §267(a)(1)** provides that no deduction is allowed for any loss from the sale or exchange of property between related persons. This treatment is referred to as the loss disallowance restriction. **(See Chapter 15A(e), Water's-Edge Manual)** However, if the related persons are corporations that are members of a controlled group, the loss is deferred (as opposed to being disallowed) until the property is transferred outside the controlled group.¹ This treatment is called the loss deferral restriction.

2. **IRC §267(a)(2)** generally requires a matching of income and deduction for transactions between related persons using different methods of accounting (cash versus accrual). One related person can deduct the expense (usually for services rendered, royalties, rent, or interest) when the other related person is required to report it as income. This rule applies to amounts that would otherwise be deductible under IRC §162, §163 and §212 and is referred to as the matching restriction. **(See Chapter 15A(f), Water's-Edge Manual)**

NOTE: This subsection is not restricted to domestic payers and payees. Congress believed, however, that the application of (a)(2) was potentially unclear when dealing with foreign payees. Thus, in 1986 congress enacted §267(a)(3) to give the IRS the ability to issue guidelines for dealing with foreign payees.

3. **IRC §267(a)(3)** provides that the IRS shall issue regulations to apply the matching principle to cases in which the payee is not a United States person. The IRS issued regulations in 1992 which, in general, require taxpayers to use the cash method of accounting for expenses paid to related foreign persons.² **(See Chapter 15A(g), Water's-Edge Manual)**

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c. Related Persons

1. IRC §267(b) lists the entities considered to be related parties. The ownership requirement generally is a more than 50% relationship. The relationships of principal concern to a water's-edge or worldwide examination are:

- A. An individual and a corporation, where more than 50% in value of the corporation's stock is owned, directly or indirectly, by the individual,³ and
- B. Two corporations which are members of the same controlled group⁴ (generally, defined as more than 50% of voting power or value). (See **Chapter 15A(d)**, Water's-Edge Manual.)

NOTE: There are also rules that apply to S corporations, partnerships, and fiduciaries of trusts. See §267(b) for more information.

2. Constructive ownership of stock rules apply.⁵ Ownership is attributed through certain relationships such as corporation/shareholder, partnership/partner, brother/sister, etc.
- A. Stock owned, directly or indirectly, by or for a corporation or partnership is considered as being owned proportionately by or for its shareholders or partners;
 - B. An individual is considered as owning the stock owned, directly or indirectly, by or for his family;
 - C. An individual owning any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;
 - D. The family of an individual includes only his brothers, sisters, spouse, ancestors, and lineal descendants; and
 - E. Stock constructively owned by an individual by reason of the rules in B. and C. cannot be treated as owned by such individual for the purpose of again

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applying either of those constructive ownership rules in order to make another person the constructive owner of the stock.

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d. "Controlled Group" Defined

The term "controlled group" for purposes of the IRC §267(f) loss deferral restriction includes the following:

A. **Parent/subsidiary controlled group:** One or more chains of corporations connected through stock ownership with a common parent corporation if:

- (1) at least 50% of the voting stock or 50% of the value of all shares of stock of each corporation is owned by one of the other corporations; and
- (2) the common parent owns at least 50% of the voting stock or 50% of the value of all shares of stock of at least one of the other corporations.⁶

B. **Brother/Sister controlled group:** Two or more corporations having five or fewer individuals that own at least 50% of the voting stock or 50% of the value of all shares of stock of each corporation.⁷

C. **Combined group:** A combined group consists of a parent/subsidiary group where the parent is also in a brother/sister controlled group.⁸

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e. The Loss Disallowance And Loss Deferral Restrictions

1. Loss Disallowance Restriction

IRC §267(a)(1) **disallows** a deduction for losses on sales or exchanges of property between related persons or parties unless the related parties are members of controlled group (in which case the loss is deferred. See part e.6 below.). The language of IRC §267(a)(1) has been viewed as being broad with no allowance for exceptions. Even if the transaction is a bona-fide transaction and is at arms's-length, the loss cannot be deducted if it occurs between related parties.

2. Definitions

- A sale generally means a transfer of property for a fixed price in money or its equivalent.⁹
- An exchange is generally considered a reciprocal transfer of property.¹⁰
- The lack of consideration can be evidence of no sale or exchange.
- The definition of "property" has been broadly interpreted, and the courts have held that IRC §267(a)(1) applies to such items as a mortgage, an interest in a partnership, and an interest in a joint account.¹¹ The courts have also held that IRC §267 applies to indirect sales and exchanges as well.

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3. Distributions In Complete Liquidation

The loss disallowance restriction does not apply in the case of a distribution in complete liquidation¹².

4. Gain Not Recognized To Extent Loss Disallowed¹³

If a taxpayer (who is not a member of a controlled group) acquires property from a related person who sustained a loss which is not allowed by reason of IRC §267(a)(1), then any gain realized by the transferee taxpayer on any subsequent sale or other disposition of the property will be recognized only to the extent that the gain exceeds the amount of the loss realized by the transferor.¹⁴

Example 1:

Mr. A owns 65% of Corp B. Mr. A sells property to Corp B for \$500. The property has an adjusted basis of \$800 at the time of sale. The loss of \$300 is not allowable by reason of IRC §267(a)(1). Corp B later sells this property for \$1,000 to an unrelated party. Although Corp B's realized gain is \$500 (\$1,000 minus \$500, its basis), Corp B's recognized gain under IRC §267(d) is only \$200, the excess of the realized gain of \$500 over the loss of \$300 not allowable to Mr. A.¹⁵

Example 2:

Assume the same facts as in Example 1 except that Corp B later sells the property for \$300 instead of \$1,000. Corp B's recognized loss is \$200. The \$300 loss realized on the sale from Mr. A to Corp B is not recognized since IRC §267(d) applies only to the nonrecognition of gain and does not affect basis in the property.

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5. Determination Of Basis And Gain With Respect To Divisible Property Under IRC §267(d)¹⁶

When more than one asset is sold at a loss to a related party, there are rules for allocating the purchase price to determine the amount realized by the transferor on the sale of the various assets. Essentially, the sales price is allocated based on relative fair market value of the assets sold. See IRC §267(d) and Treas. Reg. §1.267(d)-1(b) for more information.

The basis to the related party that purchased the assets is determined in the same manner as the transferor's amount realized. The transferor cannot deduct any loss it incurs on this sale.

When the property is eventually sold by the transferee, any gain is recognized only to the extent that the gain exceeds the amount of loss attributable to that item of property which was not allowable to the transferor.

6. Deferred Losses On Transactions Between Controlled Group Members¹⁷

The loss disallowance rule (under §267(a)(1)) and §267(d)) does not apply to losses on transfers of property between corporations in a controlled group of corporations. Instead, the transferor corporation (the selling member which realized the loss) can recognize the loss when the transferee (the purchasing member) transfers the property outside the group.

If the selling member leaves the controlled group, the loss is not recognized pursuant to IRC §267. Instead, the deferred loss is added to the basis of the asset that remains within the group. Remember, within the federal consolidated return intercompany deferral rules, deferred gain or loss is generally recognized when the buyer, the seller, or the asset leaves the group. (See Chapter 17, Water's-Edge Manual.) Unlike the consolidated return intercompany deferral rules, any loss deferred pursuant to IRC §267 is only triggered when the **asset** leaves the group. The §267(f) loss deferral rules generally override the consolidated return intercompany transaction recognition rules.¹⁸

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The loss deferral restriction does **not** apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of the group if the loan is payable in a foreign currency or is denominated in such a currency and the loss is attributable to a reduction in value of the foreign currency.¹⁹

A "controlled group" does not include a DISC, but does include a FSC.

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f. The Matching Restriction Under IRC §267(a)(2)

The general rule of IRC §267(a)(2) applies to related parties when one corporation accrues an allowable deduction that is not included in the payee's income because of its method of accounting. This section provides that a taxpayer will be denied a deduction for expenses and interest payable to a related party which are otherwise deductible under IRC §162, §163, and §212 if:

- at the close of the taxpayer's income year within which the expenses and interest accrued, the amount of the expenses and/or interest is not paid, **and**
- the amount has not been included in the gross income of the related party for U.S. tax purposes because of the payee's method of accounting (i.e. the payee is subject to U.S. tax on the income, but because the payee uses the cash method of accounting the income is not taxable until it is received).

If these conditions exist, the deduction of the expenses incurred by an accrual-method taxpayer is **deferred** until the amount payable is includible in the gross income of the related party using the cash method (this is referred to as the matching principle).

This section applies to taxpayers (payers) if the payee (the related party receiving the payment):

- is a US person, or
- is a foreign person, the payment is ECI to the payee, and the payee is subject to U.S. tax on the income.²⁰ (If the ECI amount is tax exempt per a treaty, then the matching rule does not apply, i.e. the expense is deductible when it accrues.)

For a discussion of the rules that apply if the payee is a foreign person and the payment is not ECI, refer to **Section 15A(g), Water's-Edge Manual**. See **Chapter 15A(h), Water's-Edge Manual**. for special rules for payments to foreign personal holding companies, CFCs, and passive foreign investment companies.

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NOTE: ECI means income effectively connected with a US trade or business. ECI can be foreign source income. (See Chapter 8, Water's-Edge Manual for a detailed discussion of ECI.)

Example 3:

A U.S. corporation has accrued a deduction for a management fee owed to its foreign parent. The services were performed in the U.S. and are effectively connected with the parent's U.S. trade or business. At year's-end, the fee is unpaid.

The matching principle of §267(a)(2) applies since these payments are ECI to the foreign related party. If the foreign related taxpayer reports this income on its federal/state tax return using the accrual method of accounting, then the taxpayer can take a deduction when accrued. If the foreign person uses the cash method, then the taxpayer (payor) must use the cash method of reporting the deduction.

Example 4:

Assume the same facts as in example 3 except that the management fees are not U.S. source (i.e. because the services were provided in a foreign country) and are not ECI.

Because the income is not ECI and is not U.S. source income, the foreign payee is not subject to U.S. tax on the payments. Therefore, §267 does not apply.²¹

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g. Cash Method Requirement (§267(a)(3))

IRC §267(a)(3) authorizes the IRS to issue regulations to apply the matching principle to non-U.S. persons (foreign persons). Regulations were issued which generally require a taxpayer to use the **cash method** of accounting for certain expenses that are payable to a foreign related person.²² The type of payments to foreign related parties covered by the cash method requirement are fixed or determinable, annual or periodical (FDAP) items. FDAP payments include U.S. source interest, rents, royalties, and other fixed or determinable, annual or periodical items *that are not ECI*.²³ These payments are subject to the 30% federal withholding tax imposed by IRC §1441 and §1442. The tax is imposed when the payment is made to the foreign related person. Treaties will sometimes exempt FDAP payments from tax or subject them to a lesser rate of tax. (See Section 8.6, Water's-Edge Manual for a more detailed description of FDAP income).

A foreign person includes an individual who is not a citizen or resident of the U.S., and an entity which is not a domestic corporation, partnership, estate, or trust.²⁴

1. Non-Interest Payments

If non-interest FDAP payments are made to foreign related persons, then the taxpayer/payor generally can only deduct the expense when payment is made.²⁵ However, if the related foreign person is exempt from income tax on the amount owed pursuant to a tax treaty, neither the cash method rule nor the matching rule apply.²⁶ In other words, the payor can deduct the expense when it accrues.

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2. Interest Payments

The cash method rules of IRC 267(a)(3) and Regulation §1.267(a)-3(b) apply to FDAP interest payments (U.S. or foreign source) made by a U.S. person to a foreign related party if the interest is not ECI in the hands of the foreign related party. (The presence of a treaty which exempts FDAP interest payments from tax has no effect on this rule.) Thus, FDAP interest is only deductible when it is paid. (As discussed above, the matching rule of IRC §267(a)(2), rather than the cash method rule of §267(a)(3), applies to interest payments that are ECI.)

A recent case addressed the validity of the regulation requiring application of the cash method rule for treaty exempt interest. This case involved U.S. source non-ECI interest payments made by a U.S. subsidiary (the taxpayer) to its UK parent. The taxpayer borrowed money from its parent to acquire a business. The taxpayer accrued the interest expense in one year and paid it in the subsequent year. The IRS disallowed the deduction when accrued and allowed it when paid. The UK parent was not subject to the federal withholding tax on the interest because of a treaty. The Tax Court held that because the foreign parent's interest income was exempt and would never be included in gross U.S. income, the matching principle of §267 did not apply. Therefore, the Tax Court ruled that the regulation had stepped outside the authority of §267. The appellate court overturned this decision and concluded that Regulation §1.267(a)-3 was a permissible construction of §267(a)(3). (Tate & Lyle²⁷)

3. Water's-Edge Application In Post 1991 Years

For years beginning on or after 1/1/92, CCR §25110(d)(2)(G) was amended to provide that a foreign entity must include both its ECI *and* its U.S. source non-ECI business income in a water's-edge combined report. Chapter 8, Water's-Edge Manual discusses this amendment in detail. As a result of this amendment, the cash method requirement of IRC §267(a)(3) will generally have no effect for California purposes if the following conditions are met:

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- The income has a U.S. source under federal law,
 - The foreign entity is unitary with the taxpayer, and
 - The income is business income under UDITPA

The cash method requirement will generally have no effect in these situations because the foreign entity is required to be included in the combined report to the extent of these payments.²⁸ Thus, assuming the foreign entity uses the accrual method of accounting, it will include business FDAP payments in the combined report in the year they are accrued. Including these payments in the combined report will create a "wash" since both the income and deduction are included. Cash basis rule would generally only have application if the foreign entity uses the cash method of accounting since the recipient wouldn't have taxable income subject to inclusion in the combined report until payment is made.

See [Exhibit 15A-1](#) for §267(a)(3) cash method flowchart.

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h. Payments To Related Foreign Personal Holding Companies, CFCs, And Passive Foreign Investment Companies

If payments are owed to a related foreign personal holding company (FPHC), CFC, or passive foreign investment company (PFIC), then the amount is allowable as a deduction by the payor as of the day the amount is includible in the income of the related FPHC, CFC, or PFIC. The day on which the payment is includible in the entities income is determined using the method of accounting the FPHC, CFC, or PFIC uses to compute its income and earnings and profits.²⁹

Example 5:

Pips, a U.S. corporation, is a calendar year taxpayer that uses the accrual method of accounting. Pips owns 100 percent of the stock of Frazzle, which is controlled foreign corporation. Frazzle computes its income and E&P using the accrual method of accounting. In 1988, Pips accrues an interest deduction of \$100,000 on a loan from Frazzle. Because Frazzle uses the accrual method of accounting, the interest is included in its 1988 income and E&P. Therefore, Pips can deduct the interest expense in 1988.

Example 6:

Assume same facts as example 5, except that Frazzle uses the cash method of accounting. Further assume that the interest Pips owes Frazzle is paid by Pips in 1990. Because Frazzle uses the cash method of accounting in computing its taxable income, the interest owed by Pips is included in its income and E&P in 1990. Therefore, the interest is allowable as a deduction by Pips in 1990.

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Example 7:

Frazzle and Dazzle are both CFCs owned by Pips. Frazzle computes its income and E&P using the accrual method of accounting, while Dazzle uses the cash method. In 1988, Frazzle accrues \$250,000 in interest owed to Dazzle that would be allowable as a deduction by Frazzle under its method of accounting. The interest is paid to Dazzle in 1991. Because Dazzle uses the cash method of accounting in computing its income and E&P, the interest owed by Frazzle is included in its income and E&P in 1991. Therefore, the interest is allowable as a deduction by Frazzle in 1991, not 1988.

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i. Audit Concerns

Section 267 is a potential issue whenever a taxpayer reports a material loss from the sale or exchange of property to a related party that is not included in the water's-edge group. If §267 applies, the loss is not deductible until the property leaves the controlled group. Furthermore, when the loss is triggered, the amount of the loss must be substantiated.

Example 8:

In 1996, a U.S. Corporation reports a loss from a sale of assets to a foreign affiliate that is excluded from the water's-edge group. The foreign affiliate resells the assets to a third party in 1997 for a profit. The U.S. corporation's loss is not deductible until 1997 when the assets leave the controlled group. However, the loss is only deductible at all if the fair market value of the assets was indeed greater than Corporation A's basis at the time that the assets were transferred to the foreign affiliate. Considering that the assets were sold the following year for a profit, verification of the fair market value at the time of the 1996 sale is particularly important.

Points to keep in mind when examining a §267 issue are:

- ❖ To have an IRC §267 examination issue, a member of the combined reporting group must have losses or deductions from related party transactions. Related party is defined by a **more than 50%** ownership; make sure to apply attribution rules.
- ❖ Information on related party transactions can be identified by reviewing:
 - The corporation's books and records
 - Federal Form 1120F filed by the payee
 - Federal Form 5472, Information Return of a Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Part IV of Form 5472 will show expenses being claimed by the U.S. corporation that are owed to a foreign related person.
 - Federal Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations
 - Financial Statements and footnotes
 - SEC Form 10-K and 20-F

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- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
 - Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding This form is only required when payment is actually made. If payment was made, collection of the withholding tax under IRC §1441 and §1442 should have occurred. Obtaining Form 1042 or 1042S will be a key document at audit. If Forms 1042 and 1042S have not been filed on behalf of the foreign person, there is a good chance amounts were **not paid** to the foreign person by the member of the combined reporting group.
 - ❖ Determine if a tax treaty is applicable and its impact.
 - ❖ Inspect the balance sheet for year-end accruals of expenses to related parties
 - ❖ Was a material loss reported from the sale or exchange of property?
 - ❖ A loss that has been disallowed is still considered in the computation of earnings and profits. (See Chapter 11, Water's-Edge Manual).
 - ❖ Use your professional judgment if an item is unpaid at year-end, but is paid the next year. The auditor could disallow the expense one year, but may have to allow it in the next year.
 - ❖ Other IRC sections may apply before it is necessary to apply IRC §267. For example, IRC §385, Thin Capitalization, would disallow interest expense to the extent debt is determined to be an equity investment. If large amounts of interest are being paid to the parent, the interest stripping rules per §163(j) may also be applicable. IRC §482 should also be considered when intercompany transactions are present. Thus, when a foreign person lends money at more than an arm's length rate of interest to its U.S. subsidiary, an allocation may be necessary to decrease interest expense under IRC §482. The principals of IRC §482 apply before IRC §267(f).³⁰
 - ❖ IRC §267(f) overrides any election made by a taxpayer not to defer an intercompany transaction pursuant to the IRC §1502 consolidated return rules. Therefore, even if the selling member and the purchasing member file

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a consolidated federal return where an election not to defer is in effect, the selling member's loss from the sale remains deferred pursuant to IRC §267.³¹ Similarly, for California purposes the taxpayer would not be allowed to currently recognize the loss on the sale or exchange of property between related parties even if the taxpayer has consistently used the current recognition method to report intercompany transactions in a combined report.

- ❖ Did the taxpayer fail to change their method of accounting from accrual to cash for transactions with foreign related persons? All material transactions should be verified as to date of payment.

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k. Summary

- IRC §267 acts to disallow/defer losses and unpaid deductions between related parties.
- Related party is defined as more than 50% ownership and attribution rules apply.
- If an item is not U.S. source income, then IRC §267 will not apply (except for certain interest payments).

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Footnotes

1. IRC §267(f)
2. Treas. Reg. §1.267(a)-3(b)
3. IRC §267(b)(2)
4. IRC §267(b)(3)
5. IRC §267(c)
6. IRC §1563(a)(1)
7. IRC §1563(a)(2)
8. IRC §1563(a)(3)
9. J.P. Carlton 67-2 USTC 9624; E.H. Swain 81-2 USTC 9575
10. K.A. Spalding 7 BTA 588
11. Herbert Nieman 33 TC 411 (1959); Jordan Skinner 43-2 USTC 9615 (1942); Fawcett 45-1 USTC 9306
12. IRC §267(a)(1)
13. Treas. Reg. §267(d)-1(a)
14. IRC §267(d)
15. Treas. Reg. §1.267(d)-1(a)(4)
16. Treas. Reg. §1.267(d)-1(b)
17. IRC §267(f)
18. Treas. Reg. §1.267(f)-2T
19. IRC §267(f)(3)(C)
20. Treas. Reg. §1.267(a)-3(c)(1)
21. Treas. Reg. §1.267(a)-3(b)(2)
22. Treas. Reg. §1.267(a)-3(b)
23. IRC §881(a)(1)
24. Treas. Reg. §1.267(a)-3(b)
25. Treas. Reg. §1.267(a)-3(b)(2)
26. Treas. Reg. §1.267(a)-3(c)(2)
27. Tate & Lyle, Inc. & Subs. v. Commissioner, 87 F3d 99 (1996)
28. R&TC §25110(a)(5) and (8); CCR §25110(d)(2)(G)
29. Treas. Reg. §1.267(a)-3(c)(4)(ii)
30. Treas. Reg. §1.267(f)-1T(a)(4)
31. Treas. Reg. §1.267(f)-2T(c)